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The Yen Solution

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Why dramatic currency depreciation and the resulting market resurgence are Tokyo's only way out.

Japan will emerge from its deflationary slump only when the yen is allowed to weaken.

The chief external cause of Japanese deflation is foreign direct investment in China. The chief internal cause is an excess of domestic supply capacity. Depreciation of the yen, if and when it comes, will lead to the reduction of both sources of deflation and to the eventual resolution of Japan's deflationary crisis. The great obstacle to this resolution is a system which, measured by the weight of the public sector in savings and investment, has become even more socialist than was Soviet Russia.

Not only in Japan but also in markets around the world, deflation has arisen as a result of foreign companies relocating production to China. Taiwanese corporations were the first and American corporations have become the biggest investors in China. But it is Japanese producers of exportable goods whose direct investments, driven by the strong yen, are having the most deflationary impact on the global economy. As long as the overvalued yen keeps their domestic operating costs prohibitively high, Japanese producers will increasingly tap deeply into the Chinese labor market, causing consumer-goods markets in Japan and worldwide to continue to be flooded with cheap China-made electronics, textiles, and other products. Thus, until the overvaluation of the yen is corrected, China will be a growing external source of deflation, for the world generally and for Japan particularly.

A more important source of Japanese deflation, however, is excess supply capacity within Japan. This problem is by no means unique to Japan. But after Japan consented to a strong yen in the Plaza Accord of 1985, it became the first country to experience the investment bubble that eventually spread through Asia, the United States, and Europe. As such, Japan has been first to face the deflationary consequences of oversupply.

Japan's economic bubble of the late 1980s was not, as is often thought, primarily a property and equity bubble. It was primarily a capital investment bubble. Three-quarters of debt cre-

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ated during the bubble years stemmed from new investment in supply capacity. Consequently, excess supply capacity in the Japanese economy as a whole has remained at around 30 percent since the capital investment bubble reached its peak in 1991. Japanese manufacturers, after twelve years of attempted adjustment, are still operating at less than 70 percent of capacity. Fundamentally this is not a problem of lack of demand; it is a problem of chronic oversupply.

It is tragic that many observers, both inside and outside Japan, are still unable to see that demand-side policy has not worked and cannot work. Have twelve years of Japan banging its head against a brick wall not been proof enough of a failed policy? It remains to be seen whether the United States and Europe, when forced to confront their own problems of excess supply capacity, will be able to learn from Japan's experience. Intuitively, one feels that the United States is likely from the outset to let the market restore balance, whereas continental Europe is likely to resort to a socialist agenda—perhaps even to the extent of nationalizing both banks and major corporations—thereby compounding Japan's error.

The truth is that balance could never be restored to Japan's post-bubble economy through government management, no matter how skillful, of demand; balance can be restored only through market-driven reduction of supply. To this end, interest rates, which at close to zero are providing artificial life-support for inefficient suppliers, must be allowed to rise substantially.

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Japan's 30 percent excess supply capacity translates into 20 million redundant workers out of a total workforce of 65 million. The goal should be that only 45 million of these workers, working at 44 percent greater efficiency, produce the current level of GDP. This would allow the reemployment of the redundant 20 million to drive future GDP growth. An interest-rate hike to around 5 percent would be appropriate to set the economy moving in this direction.

The scrapping of supply capacity that cannot yield a rate of return of over 5 percent would reveal the true extent of Japan's non-performing loan problem, probably necessitating a temporary nationalization of the banks. At the same time, in the early stages of the adjustment, it would bring about a seemingly catastrophic rise in unemployment. From the political viewpoint, therefore, supply side reform via higher interest rates is a hideous prospect. From the economic viewpoint, however, a large hike in interest rates is the only way forward: it holds the promise of vastly improved allocation of resources to those deserving companies that survive the weeding-out process.

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Ironically, higher interest rates would have beneficial spin-offs on the demand side too, by reviving interest income on the ¥1,000 trillion in net financial assets held by households. An interest-rate hike to 5 percent would create interest income of ¥50 trillion, or about 10 percent of GDP. This new income could create demand for new businesses, especially in Japan's underdeveloped service industries.

If new demand for services is to be met, however, existing supply-side disincentives to entrepreneurship must be eliminated. Deregulation and tax reform are vital. Currently the effective corporate tax rate is 40 percent, but deductions are allowed for depreciation and interest payments. If these deductions were included in taxable income, and the overall tax rate were lowered to 10 percent, this would help in the re-allocation of resources from large, unwieldy, capital-intensive companies, to small, dynamic, entrepreneurial ones. It is chiefly these latter small businesses whose emergence and growth, centered on the supply of new services, will provide Japan's redundant workers with meaningful reemployment.

How much time might it take for 20 million workers to shift into newly created jobs? If the whole process took 10 years, an annual shift of two million workers would be required, resulting in an annual rise in productivity and economic growth of 3 percent. If the process took five years, a yearly shift of four million would be required, accompanied by a 6 percent rise in productivity and growth. A six-to-seven-year plan would probably be ideal, with a required repositioning of around three million workers per year and an annual rise in productivity and growth of between 4 percent and 5 percent.

With the Japanese unemployment rate already hovering at a post-war high, creating more unemployment through higher interest rates is conspicuously counter-intuitive. No politician would even dream of advocating a course which, to the ordinary Japanese voter, seems to promise economic self-destruction. This being so, any significant increase in interest rates will be realized not through political initiative but through market forces. Specifically, I anticipate that capital flight from Japan and depreciation of the yen will form a vicious circle, culminating in the collapse of the Japanese government bond market and a consequent major rise in interest rates.

Readers of *The International Economy* have seen this prediction before and may ask themselves why it has not yet come to pass. Depreciation has been delayed because Japan, in its reaction to post-bubble deflation, has reverted to a kind of corporate socialism, protecting weak companies through rapid and massive increases in public spending.

In the eleven years from 1990 to 2001, both public financial institutions—which absorbed the lion's share of new savings—and private financial institutions invested much more in government bonds and public corporations than in private investment vehicles. Thus, no less than 90 percent of all new savings was wastefully invested in the inefficient public sector. It is unlikely that even the Soviet state monopolized savings so effectively.

Inevitably, financial investment overseas remained minimal. The Japanese system, guided not by market principles but by the inscrutable hand of corporate socialism, failed to recycle Japan's current account surplus. Money that should have flowed abroad, causing the yen to depreciate, was squandered on the building of meaningless bridges and roads to nowhere. Instead of depreciating, and thereby stimulating the necessary rise in interest rates, the yen remained overvalued, allowing interest rates to sink to zero, and causing Japan to remain stuck in the deflationary mire.

Again, it is because Japan's financial markets are not functioning properly that the Bank of Japan has been unable to increase the money supply in any meaningful way. The arguments of foreign monetarists are based not only on the premise that demand-side policy can succeed, but also on the premise that the Japanese economy is functioning according to market principles. I hope to have shown that both premises are wrong. Since 1991, Japan's economy has been more socialist than that of any socialist country in history.

There are signs, however, that the market may be on the verge of reasserting itself, now that conditions which allowed the Japanese authorities to maintain the status quo no longer hold. Domestically, banks' unrealized capital gains from equity holdings, and the government's budget surplus, have both turned into deficit. Externally, the U.S. economic boom which protected the Japanese economy through the 1990s, along with the foreign equity investment that supported the Japanese stock market, have both ended.

Most tellingly, the Japanese household sector, which traditionally does not invest overseas, is beginning to see the light. This sector's overall investment in foreign securities, and foreign bonds in particular, has accelerated of late and will accelerate further as individual savers become more clearly aware of how Japan's financial system has failed them.

If this increase in investment in foreign currency-denominated assets establishes a weak-yen trend, then exporters, for example, will cease buying yen to hedge their dollar-denominated export revenues. Capital flight and depreciation of the yen will thus feed each other, finally leading to a collapse in the Japanese government bond market and the long-awaited rise in interest rates.

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The exchange rate at which purchasing power parity exists between Japan and the United States is around ¥170 to the dollar on a consumer price basis and around ¥125 on a producer price basis. In estimating the latter figure, however, account should be taken of Japanese manufacturers' as yet unreformed habit of operating on low margins. Under the assumption of equivalent profit margins, purchasing power parity on a producer price basis would be around ¥150 to the dollar. Overall, purchasing power parity probably exists at around ¥160 to the dollar. A rapid depreciation of the yen toward this level, accompanied by a bond market crash in which the interest rate leapt toward 5 percent, would reveal whether professed reformers are really prepared to embrace reform.

Policymakers in Japan and abroad pay lip service to the idea of reform but fear the very change that will cause reform to happen. In the final analysis, human wisdom is always limited. It may be best to let the market decide. ◆